Testimony Submitted
To
The United States House of Representatives
Committee on Financial Services

April 25th, 2003

Kevin A. Hassett*
AEI

*Dr. Kevin A. Hassett is Director of Economic Policy Studies at the American Enterprise Institute.

Introduction

There is no question that our political process has produced a fiscal policy machine that spews out promises to voters that—while providing short-term benefits to politicians of both parties—expose our nation and our economy to significant long-run risks. As we gather this week to consider new fiscal policies, it is my belief that much valuable perspective can be gained from a careful enumeration of our most difficult problems.

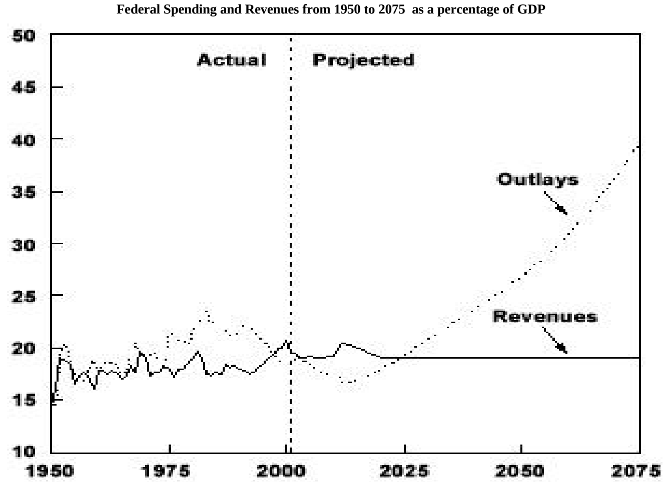
A look into the distant future can help provide insights into the strength and weaknesses of different proposals today. I will focus on the two issues that I believe are the most important. I will then discuss the extent to which current proposals adequately respond to these challenges.

The Coming Train Wreck and Its Causes

It is common knowledge that the long run fiscal position of our nation is very poor. Under current policies, for example, federal deficits as large as 20 percent of GDP have been forecast by the Congressional Budget Office (CBO) over the next 75 years. Such observations provide powerful ammunition to those who would oppose tax reductions at the present time. If we are headed for enormous deficits in the future, how can we possibly cut taxes today?

Figure 2

Federal Spending and Revenues from 1950 to 2075 as a percentage of GDP



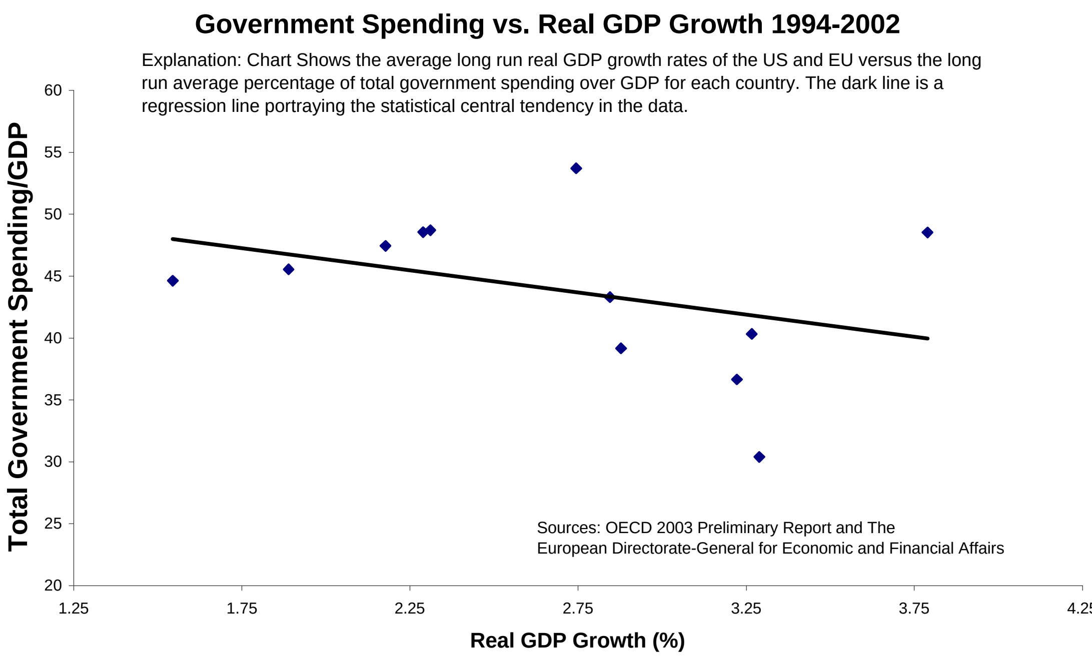
A look at the underlying details, however, suggests a possible answer. The problem is not caused by taxes, but rather by spending. Figure 1, which has been constructed from CBO data, provides a graph of projected federal spending and revenues from 1950 through 2075. These data include all of the tax reductions of the past few years, but do not include any proposed changes to law this year. The chart tells an interesting story. The "train wreck" is attributable to a projected explosion of government spending. Total federal government spending increases over these decades from about 20 percent of GDP to about 40 percent of GDP. Revenues, on the other hand, hold steady at 19 percent of GDP. Since GDP grows over this period, revenues do as well. Revenues are not lower than they are today in 2075, but much higher. Spending, however, is higher still. If one assumes that state and local government spending will likely follow a similar path, then one can conservatively conclude that government spending is currently on a course that will lead it to consume almost 60 percent of GDP by 2075, about double the current percentage of GDP devoted to government spending. This does not happen because of new policies. Government will consume 60 percent of GDP if we do nothing. It will consume significantly more than that if prescription drug coverage is passed this year.

If the long-run imbalance is attributable to spending outracing revenue, then Congress has two choices. It can control spending growth, or it can raise taxes. Neither choice is politically popular. Controlling spending means that promised benefits for senior citizens will be reduced. Increasing revenues only continues government on a path to consume more than half of GDP.

Enough policymakers have argued that long-run deficits make tax reductions today "irresponsible" that it is worth exploring the implications of a government that large. For implicit in the anti-tax-reduction view must be the belief that "responsible" tax policy will raise tax rates until the long-run budget is balanced. Under current policy, the combined government of the U.S. is on target to be about 30 percent larger than the current federal government of France, which already consumes nearly 50 percent of its nation's GDP.

This large devotion of resources to government would undoubtedly have negative economic consequences. Economists have generally found that countries with large governments grow slower than countries with small governments. This relationship is clearly evident in the data.

Figure 2



For example, Figure 2 indicates for a sample of OECD countries that countries with smaller governments have significantly outperformed countries with large governments. The most likely explanation for this pattern is that governments tend to be much less efficient than private individuals.

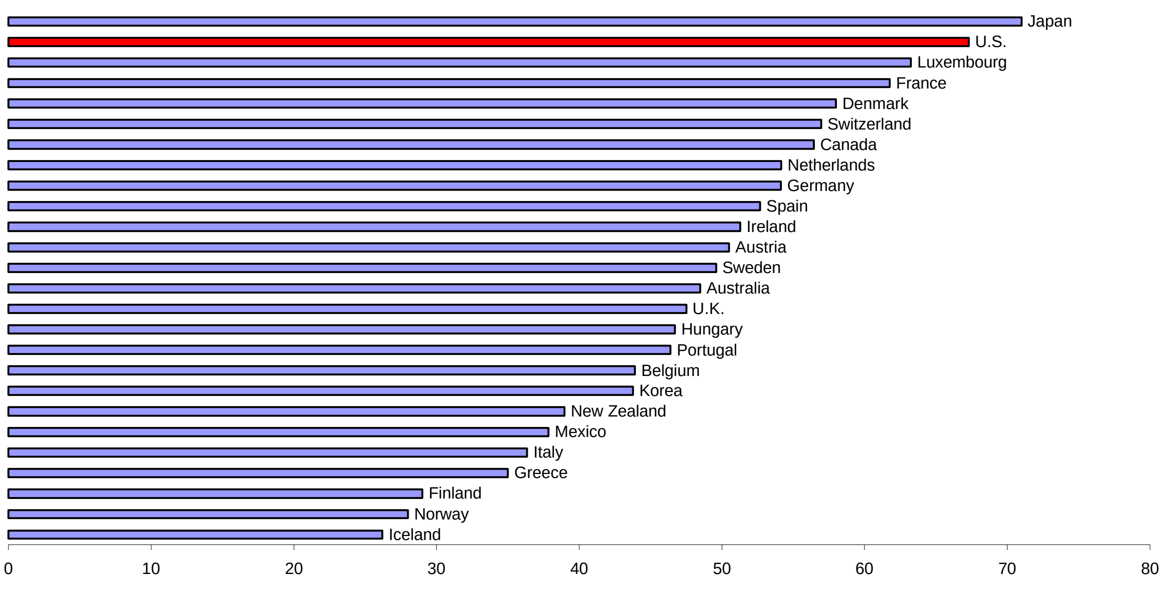
Since very few among us want our country to become France, it is useful to consider how this problem will work itself out. It is my opinion that we will either have a large entitlement reform or a long sequence of small tax increases. Even small tax reductions today, then, make the high tax path less likely. This is because they increase the politically-difficult tax increases required to close the gap between revenues and spending in the future. My own guess is that we will ultimately recognize that it is foolish to bankrupt ourselves by paying ourselves ever-richer retirement benefits. Real GDP is forecast by the CBO to be almost 7 times higher than it is today in 2075. Since social spending is motivated by a worthy concern to provide a safety net, one might conjecture that the case for high across-the-board social spending weakens as income rises. Finally, it may well be difficult if not impossible to solve these problems with tax increases. A recent study of OECD countries, for example, found that fiscal adjustments that rely upon spending cuts have tended to successfully restore fiscal discipline. Those that rely on tax increases failed to.[1]

The U.S. Corporate Tax Code Must Be Reformed

The second pressing problem is the terrible state of our corporate tax code. While U.S. corporate tax policy has seen little change over the past decade, the rest of the world has been active reducing tax rates. As a result, the U.S. has acquired an extremely unfavorable position relative to the rest of the world.

Why is the rest of the world reducing taxes on capital income? The best explanation is that the view accepted by most economists that high capital income taxes can be harmful to economies has received a fairly broad acceptance among our trading partners. Since the U.S. has lagged behind, we now find ourselves in the uncomfortable position of being second only to Japan in the degree to which we tax corporate income. As can be seen in Figure 3, which plots the combined corporate and dividend tax across countries, the evidence is striking.

Figure 3
Combined Corporate and Personal Dividend Tax Rates (2003 Under Current Legislation)

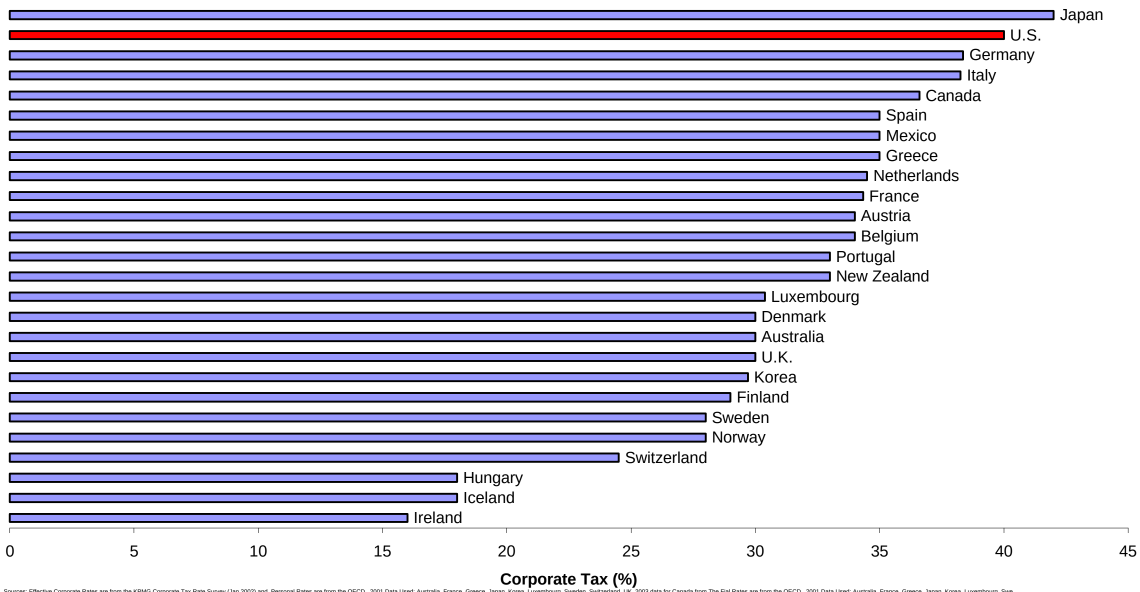


Sources: Effective Corporate Rates are from the KPMG Corporate Tax Rate Survey (Jan 2002) and Personal Rates are from the OECD. 2001 Data Used: Australia, France, Greece, Japan, Korea, Luxembourg, Sweden, Switzerland, UK. 2003 data for Canada from The Fin Canada, Belgian Data from Price Waterhouse Coopers and Italian data from Deloitte.

[1] Alesina, Aleberto, and Perotti, Roberto, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects." NBER Working Paper No. 5730, August 1996.

As Figure 4 demonstrates, the result is not solely attributable to the double tax on dividends. The U.S. corporate tax rate is second from the top as well.[2]

Figure 4
Effective Combined Top Central and Local Corporate Tax Rate (2003)



Sources: Effective Corporate Rates are from the KPMG Corporate Tax Rate Survey (Jan 2002) and Personal Rates are from the OECD. 2001 Data Used: Australia, France, Greece, Japan, Korea, Luxembourg, Sweden, Switzerland, UK. 2003 data for Canada from The Fial Rates are from the OECD. 2001 Data Used: Australia, France, Greece, Japan, Korea, Luxembourg, Swe

These figures should provide food-for-thought for those who would contend that the reduction in double taxation disproportionately benefits the wealthy. If that were true, why do Scandinavian countries with historically strong social welfare objectives tax corporate capital at a lower rate than ours? The answer is simple. High tax rates encourage firms to locate elsewhere. When this occurs, shareholders may come out ahead, but workers will not. The best policy for a country is to make itself as attractive as possible to capital. If it does succeed in keeping its own capital at home and luring foreign capital in large quantities, everyone will benefit. Workers will have higher wages, government will receive higher tax revenues, and investors will reap higher returns. The U.S. and Japan are among the few countries not to have recognized this.

One should not take these tax disadvantages lightly. Under current law, for example, a U.S. firm intent on paying dividends has to have more than double the after-corporate tax profit of a Norwegian firm in order to offer a taxable shareholder the same after-tax cash flow.

It is my belief that international tax competition is going to put ever-increasing pressure on the U.S. to sharply reduce taxes on capital income. This pressure will make it very difficult to solve the long-run fiscal crisis by increasing tax revenues.

[2] A number of countries have recently stepped away from imputation systems, but after significantly lowering their corporate tax rates. This highlights the fact that it is not the "double tax" that presents the problem, but the combined tax rate on corporate income.

Current Tax Proposals and the Long-Run Debate

Nothing on the current agenda fundamentally addresses the long-run budget imbalance. However, even the largest of the proposals currently in play—a tax reduction of $550 billion over then next ten years---is miniscule in size relative the economy and the long run problem. The annual cost, statically scored, of any likely proposal will be around one half a percent of GDP. [3]

The President's plan to reduce dividend tax rates has a strong appeal given the second problem. Income that has been taxed once will not be taxed again. It will not be taxed at the shareholder level if the corporation uses its income to pay a dividend. Capital gains that are attributable to the retention of after-tax corporate income will also not be taxed. While there are many challenges ahead, this is a major step in the right direction, significantly reducing the gap between the U.S. and its competitors.

What would the effect of dividend tax reduction be? The largest and most direct effect will likely be a stimulus to capital spending. This will increase economic growth and give society more resources to devote to its long run problems.

The literature relating tax factors to firm capital spending was reviewed recently by Hassett and Hubbard (2002).[4] We found that economists have often identified strong effects of tax policy on investment behavior. The literature on *dividend* tax policy and investment has had a rather contentious history. Theoretically speaking, it is possible to derive cases where dividend taxes have a large effect on investment, but other cases exist that are equally plausible that suggest that dividend taxes have a smaller effect. An early and pathbreaking study by Poterba and Summers (1985) concluded, "our results suggest that dividend taxes reduce corporate investment and exacerbate distortions in the intersectoral and intertemporal allocation of capital".[5] A more recent study that I coauthored with Alan Auerbach of the University of California at Berkeley found evidence that supported somewhat smaller economic effects of dividend tax reductions.[6]

Accordingly, it is appropriate given the academic literature to be somewhat cautious concerning the likely investment effect of the President's plan, and to account for the eventuality that perhaps as many as half of firms will respond in a small way. Calculations that I have performed confirm the recent testimony of the Chairman of the Council of Economic Advisors that the reduction in the net cost of a new equipment investment associated with the President's proposal is in the range of 4 to 7 percent.[7] If one is willing to assume that state and local taxes will also be eliminated in response to the federal action, the effects can climb higher. To put these reductions in perspective,

[3] The word "cost" in this context is rather loaded. The reduction of a tax is not traditionally described as a cost in the economics literature. The revenue lost by the government remains with the original taxpayer and does not simply disappear.

[4] Kevin A. Hassett and R. Glenn Hubbard (2002), "Tax Policy and Investment," in A. Auerbach and M. Feldstein eds., *Handbook of Public Economics*, volume 3, pp. 1293-1338.

[5] Poterba, J.M., and L.H. Summers, "The Econonomic Effects of Dividend Taxation", (1985) in E. Altman and M. Subrahmanyam, eds., *Recent Advances in Corporate Finance*, pp. 227-284.

[6] Auerbach, A.J., and K.A. Hassett (2003), "On the Marginal Source of Investment Funds," *Journal of Public Economics*, 87, pp. 205-232.

[7] Testimony of R. Glenn Hubbard before the Senate Budget Committee, February 3rd, 2003. Other calculations suggest that the impact on incentives to invest in nonresidential structures is much greater than that, but the empirical link between the marginal incentive to invest and structures investment is much weaker.

the low end of Dr. Hubbard's range is approximately the same reduction in the cost of new investments achieved by last year's stimulus bill that included temporary partial expensing. The high end of the range provides about double the stimulative effect of the 2002 temporary partial expensing provision.[8]

If capital spending does respond proportionately to the increased incentive to invest, then simple arithmetic suggests that the true revenue cost of the dividend tax proposal may be very close to zero, and will certainly diminish over time. [9] Thus, it is simply incorrect to state that dividend tax reductions are too costly given our budget circumstances.

I would argue that each fiscal policy measure that Congress adopts be measured against these pressing problems. Does the tax or spending change provide a strong foundation for economic growth? Does it worsen our already difficult problems? By this measure, the dividend tax reduction deserves high grades.

To be sure, other policies currently in play have significantly less economic merit than dividend tax reductions. Politically popular changes such as marriage penalty relief and the child credit will do little to strengthen the economy. The proposed introduction of a drug benefit for our senior citizens could have an exploding cost over the next few decades, significantly exacerbating our long run challenges.

It is exactly these policies that we should not adopt until the long-run entitlement problems are resolved. As the members of this august Committee discuss policy changes, they must keep these facts in mind. Indeed, to the extent that revenue shortfalls are a concern for some when considering dividend tax proposals, a solution is readily at hand. In order to adopt the policies that improve the efficiency of the tax code, budget hawks should be willing to pay for reforms by passing up tax measures that are more sound bite than sound policy. The gravity of our long run problems makes any alternative unacceptable.

---

[8] The incentive effects of the Job Creation and Worker Assistance Act of (2002) were discussed in, Cohen, D.S., Hansen, D.P. and K.A. Hassett (2002), "The Effects of Temporary Partial Expensing on Investment Incentives in the U.S.," *National Tax Journal* Volume LV, *No. 3, pp 457-466.*

[9] I should note that alternative proposals that simplify the President's proposal by disconnecting the dividend tax reduction from the corporate tax status of the firm have similar economic effects when the personal dividend tax is reduced by between 50 and 70 percent.